FULL COMMITTEE HEARING ON THE STATE OF THE SMALL BUSINESS ECONOMY

COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

NOVEMBER 7, 2007

Serial Number 110-58

Printed for the use of the Committee on Small Business

Available via the World Wide Web: http://www.access.gpo.gov/congress/house

U.S. GOVERNMENT PRINTING OFFICE

39–379 PDF WASHINGTON : 2007

For sale by the Superintendent of Documents, U.S. Government Printing Office
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FULL COMITTEE HEARING ON THE STATE OF THE SMALL BUSINESS ECONOMY

Wednesday, November 7, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to call, at 9:05 a.m., inRoom 2360, Rayburn House Office Building, Hon. Nydia M. Velázquez [Chairwoman of the Committee] Presiding.

Present: Representatives Velázquez, GonzaAE1lez, Clarke, Sestak, Chabot, Bartlett, Akin, Fortenberry, Heller, Davis, Buchanan and Jordan.

OPENING STATEMENT OF CHAIRWOMAN VELÁZQUEZ

ChairwomanVELÁZQUEZ. Good morning. I am pleased to call this hearing to order. Thank you all for being here today.

Today's hearing will examine the production, employment, and output of our Nation's small businesses as the driver of the U.S. economy. There can be little doubt that, at its heart, our Nation's economy is truly a small business economy. Research has shown that small businesses create most of the Nation's net new jobs and account for almost half of our employer firms. Additionally, they produce more than half of the country's nonfarm private output.

It goes without question that small firms make significant contributions to the U.S. economy. Today's hearing will provide a forum to hear the Federal Reserve's perspective on small businesses' contributions to the economy. This comes at a time when we are seeing mounting challenges in the financial markets. These challenges, stemming mainly from the housing market, may spill over to other sectors of the economy. This would have broad ramifications, including an impact on small businesses.

Despite this recent turmoil, small businesses remain a critical source of growth. A number of new businesses measured as the number of firms created has shown a net increase of over 20,000 since 2004. Just last week, the Labor Department reported nationwide job growth of 156,000 new jobs and a stable rate of unemployment. Small businesses were at the heart of these metrics. And whatever our economic future may hold, we can be assured that small businesses will be the vanguard for production, job creation, and output nationwide.

Recently, however, we have witnessed increased volatility in the capital markets. These conditions have been driven primarily by weaknesses in the mortgage sector, but virtually every business sector has been affected by these events. Mortgage market instability has resulted in a tightening of lending standards that has spilled over into the small business credit markets. Indicators reflect that entrepreneurs are experiencing difficulty obtaining credit, and more banks are reporting lower demands for small business loans.

I am sure it comes as no surprise to members of this Committee that small businesses have more difficulty gaining access to an affordable source of credit compared to large businesses or other types of borrowers. Unfortunately, the most recent Federal Reserve report on the availability of credit to small businesses revealed that this continues to be the case.

Small businesses continue to rely disproportionately upon more expensive alternatives to traditional credit than larger businesses. Additionally, the percentage of small businesses that use credit cards increased nearly 10 percent since the last Federal Reserve survey. These results demonstrate the need for strong Small Business Administration programs aimed at providing small firms with access to affordable sources of financing.

Yet, despite the obvious importance of small businesses, there remains few studies on their economic role. In addressing the need for solid information on small businesses, few studies have been more influential than the Federal Reserve's report to Congress on the availability of credit to small businesses. Much of the information contained in the report is gleaned from the Survey of Small Business Finance, which is itself the most comprehensive and up-to-date assessment of small business finance. Over the past decade, this report has provided Congress with invaluable insight into the small business credit markets. Now, more than ever, such insight is the key resource in developing balanced and effective economic policies.

With the economic turmoil we have seen recently, it is paramount that we all work together to restore financial market stability and upset the effects of tighter credit conditions. These developments have created uncertainty over our economic future. Our history has proven that as small businesses go, so goes the national economy. In this environment it is more important than ever that this Committee remain committed to ensuring that small businesses have access to the financial tools they need to grow and thrive.

I want to thank Governor Mishkin for his testimony in advance, and I now yield to the Ranking Member Mr. Chabot for his opening statement.

OPENING STATEMENT OF MR. CHABOT

Mr.CHABOT. Thank you, Madam Chair, for holding this hearing this morning to examine the state of the small business economy.

And I think we all want to thank you as well, Governor Mishkin, for taking time out of your very busy schedule to be with us today to share your views on this very important topic.

While the U.S. economy faces real challenges, credit worries, rising energy costs, and a slowing housing market, among others, the October Bureau of Labor and Statistics Employment Summary and the preliminary estimates of third quarter GDP growth show an economy that is expanding. Job growth in the third quarter was the strongest since the early spring of 2007, with an estimated 166,000 new jobs created just last month in October. The strongest month for job creation since May, October marked 50 months of consecutive job growth, 50 months of consecutive job growth.

In addition to these positive trends, we have seen wage increase and growth of the gross domestic product remain steady. These numbers surpassed expectations, indicating entrepreneurs and small businesses continue to create new jobs, and the labor market and overall economy remains strong. These numbers provide great insight into the strength of our small business economy.

Because of their importance to our overall economic health, and we all know the statistics, we must continue to be mindful of how the policies we pursue and enact here in Congress will affect small businesses as we move forward.

I am concerned over some of the tax policy initiatives that have been coming from the Ways and Means Committee leadership in the last few weeks. As the White House noted, the most recent legislation would dramatically raise taxes on millions of small businesses, stifling their ability to grow and create jobs. Coupling this legislation with runaway government spending, we are setting up a scenario that would put a wet blanket on future growth. Small businesses are vital to future economic growth, and I believe that these regressive tax-and-spending policies put our economic well-being in danger.

I am very eager to hear today how the Federal Reserve Board is responding to the credit crunch in the wake of the housing market downturn. I am interested to learn the Board's forecast for how the credit crunch is affecting our small businesses now, and how further trickle-down from the housing market fallout will affect them in the future.

I think I speak for many of my colleagues when I say that we in Congress would like to know how we can help both individual Americans and businesses weather the current credit market crunch.

I look forward to working with Chairwoman Velázquez and all of our colleagues in this Committee to ensure that this Congress does more than just talk about how small businesses are our economic engine, but also acts in accordance with that reality. Under the Chairwoman's leadership, this Committee has remained cognizant of small firms' proficiency in generating jobs and ability to grow our economy, and we will continue to ensure small businesses receive their fair shake.

Just one point. I can't overemphasize how concerned I am about the proposed mother of all tax bills that is being considered in the Ways and Means Committee. That gives me and, I think, many other people great concern about the impact that could have on the small business community; because the taxes that the Chairman of that particular Committee is talking about would fall probably most heavily on small business owners. That is the people that would really be targeted by that. And I think we in this Committee should do everything within our power to get that less powerful Committee to back down to this more powerful Committee.

Chairwoman VELÁZQUEZ. Well, thank you, Mr. Chabot. But I just would like to add for the record that the mother of all taxes is a long way in front of us. What is more important for us today is the mortgage market instability and how that could spill over to other sectors of our economy, and the immediate impact on small businesses.

So, Governor Mishkin, it is a pleasure to have you here today. Dr. Mishkin sits on the Federal Reserve Board of Governors, having taken office on September 5, 2006. Before becoming a member of the Board, Dr. Mishkin was the Alfred Lerner Professor of Banking and Financial Institutions and A. Barton Hepburn Professor of Economics at the Columbia University Grad School of Business. During his career, Dr. Mishkin has also served the Federal Reserve System in several roles, including executive vice president and director of research at the Federal Reserve Bank of New York, and an associate economist of the Federal Open Market Committee of the Federal Reserve System.

Dr. Mishkin is the author of more than 15 books and numerous articles in professional journals and books. Dr. Mishkin is one of the most respected scholars on monetary policy and its impact on financial markets and the aggregate economy.

You are most welcomed.

STATEMENT OF FREDERIC S. MISHKIN, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. MISHKIN. Thank you very much for that kind introduction.

Chairwoman Velázquez, Ranking Member Chabot, and members of the Committee, I am pleased to appear on behalf of the Board of Governors to discuss the availability of credit to small businesses.

Small businesses play a critical role in the U.S. economy, and access to credit is essential for this success. As you know, the Board is required to report to the Congress every 5 years on the status of small business access to credit, and our most recent report was submitted on October 26. While I cannot discuss all of the topics covered in our report, I would like to mention a few highlights. I will then briefly address how the unusual stresses imposed on credit markets in recent months may affect small businesses. So let me turn to the highlights of the 2007 report to Congress.

Our 2007 report indicates that, since our last report in 2002, financing flows to small firms generally increased along with economic activity. Credit conditions during the period were favorable for small firms, and we have no evidence that credit-worthy borrowers faced any substantial constraint on their access to credit.

Although small businesses obtain credit from a wide range of sources, commercial banks are today, as in the past, the leading provider. Our report shows that, among small businesses, relatively large firms and a lot of the older firms were more likely than smaller, younger firms to use a wide range of types of credit and were more likely to have their credit applications approved. These results are consistent with the conventional view that smaller and younger firms are riskier, have shorter credit histories, or less collateral to pledge as security, and are generally harder for lenders to evaluate because they are less transparent.

As was true in 2002, the 2007 report emphasized the importance to small businesses of geographic proximity to their sources of credit. The importance of local providers of credit to small businesses underscores the need to preserve competitive banking markets at the local level. Despite the significant consolidation that has occurred in the banking industry, competitive conditions in the Nation's local banking markets have remained quite stable.

The use of credit scoring in assessing small business credit applications has become common only since the mid-1990s. Evidence suggests that the use of credit scoring increases credit availability to some small businesses. Users of credit scoring models generally report that, after their adoption, the riskiness of the small business portfolio remains about the same or it declines, and the quality of the typical credits decision increases.

The obstacles to securitizing most loans to small businesses remain large. The securitization of small business loans has remained modest, and is unlikely to increase substantially over the foreseeable future.

So let me turn to small businesses finances and recent financial market developments. I will now comment briefly on the possible effects of the recent financial market turmoil on small business access to credit. I emphasize that the possible effects are complex; that we do not yet have much hard evidence; and that it is far too early to draw any strong conclusions.

That being said, there are good reasons to believe and some evidence to suggest that the recent financial market disruptions have not seriously harmed access to credit by small businesses; and, if the disruptions continue to be resolved in an orderly manner, it will be unlikely to do so in the near future.

For example, the current turmoil has centered on securities backed by nonconforming residential real estate loans and loans or other debts of relatively large firms. Because the securitization of small business loans is still quite modest, we would not expect turmoil in the markets for securitized assets to have a large direct effect on small business lending.

Recent events have nonetheless almost surely had some negative effects on small business access to credit, and we cannot rule out further effects. For example, recent surveys have found that the market for small business credit has tightened. These surveys also suggest that, at least for now, the effects have generally been quite limited.

Perhaps one of the most important concerns for small business access to credit is that many small businesses use real estate assets as collateral. Looking forward, a reduction in the value of their real estate assets has the potential to adversely affect the ability of those small businesses to borrow. Similarly, declines in the value of real estate assets held by banks and other lenders may affect their ability to supply loans, as real estate losses use up capital that could otherwise be used for making new loans.

Fortunately, the vast majority of U.S. Banks are well capitalized, and thus should be able to maintain their lending capacity. Still, the possibility remains that reductions in real estate values and other factors could affect small business access to credit. The Board will be monitoring the economy for signs of possible effects over the next few months.

So, let me conclude. In conclusion, the health of the U.S. economy depends importantly on the vitality of the small business sector. Our 2007 report indicates that since our 2002 report, small business access to credit has been robust. Credit conditions have no doubt tightened since mid-August, but small businesses seem generally to have been able to retain access to credit. However, the current level of uncertainty is unusually high. Thus, the Federal Reserve will continue to monitor closely the effects of financial market conditions on small business finances as part of our efforts to ensure that the stress on foreign financial markets does not spill over into the broader economy.

Thank you. I would be happy to answer any questions you may have.

ChairwomanVELÁZQUEZ. Thank you, Governor Mishkin.

[The prepared statement of Mr. Mishkin may be found in the Appendix on page 30.]

ChairwomanVELÁZQUEZ. In fact, you discussed the effect of the recent tightening of credit standards has on small businesses and financing. So my question to you is to what extent does the SBA's lending—Small Business Administration lending and investment programs bridge gaps in private markets for access to financing during periods of tighter credit conditions?

Mr.MISHKIN. Well, SBA financing, I am sure, does help; but the recognition is that it is actually only a small part of actually financing of small businesses, on the order of 5 percent. So clearly what is really very key is the overall health of the U.S. economy and also the overall health of the financial system to be able to provide the credit to small businesses.

ChairwomanVELÁZQUEZ. The Federal Reserve makes policy decisions weighing both inflation and economic growth. During the September 18 Federal Open Market Committee meeting, the decline in inflation was expected to be sustained throughout the year, but needed to be watched carefully. The meeting minutes stated that inflation remained a risk due in part to the continuing weakness in the dollar. How has the recent slide in the value of the dollar affected your inflationary expectations?

Mr.MISHKIN. Well, clearly when the dollar declines in value, that increases both the prices of imports, what we buy from abroad, but actually also increases the demand for exports and therefore prices for exports. In fact, we think of these as just tradable goods, and it actually would lead to higher prices in those goods.

However, the pass-through of the effects of exchange rate depreciation are very much affected by how anchored inflation expectations are. If inflation expectations are well anchored, which is extremely important and, in fact, part of what the Federal Reserve needs to achieve and has achieved in recent years, then we find that the impact of the dollar depreciation on the overall price level is actually quite limited.

ChairwomanVELÁZQUEZ. Sir, with the weaker dollar and inflation concerns expressed by the Board in meeting minutes, are some inflationary risks being ignored?

Mr. MISHKIN. Well, I hope not. We definitely don't want to ignore them. It is extremely important to the health of the economy that inflation, in fact, remains contained. This has been one of the great successes of the Federal Reserve System in recent years and, actually, also in other central banks throughout the world. Indeed, if you anchor inflation expectations and anchor inflation, it actually gives you more flexibility to deal with negative shocks to the economy.

Chairwoman VELÁZQUEZ. We all know that businesses of all sizes must plan and account for inflation. Would you please describe to us your view on the idea of an explicit target, explicit inflation target, and its likely effects on small business' ability to make informed decisions?

Mr. MISHKIN. Well, at this stage the Federal Reserve has been discussing communication strategies, so I really don't want to comment on the issue of inflation target. What I will say, however, is—

Chairwoman VELÁZQUEZ. But let me ask you, can you discuss how an inflation target impacts the small business sector?

Mr. MISHKIN. Well, I think the issue here is rather than thinking so much of an inflation target impacting the small business sector, the way I would think about this is the control of inflation and how that impacts the small business sector; that clearly having price stability, which is part of our dual mandate, and not only do we care about price stability, but we also care very much about what happens to economic growth and employment—but having price stability actually makes it much easier for small businesses to plan and make better investments and, therefore, do better actually.

I come from a small business background, actually maybe even was in your district. There was manufacturing in Manhattan, quite extensive manufacturing, which, of course, is no longer there. And I worked in my father's plant, and, in fact, it is now a restaurant, by the way, which is what has happened to Manhattan. It was on West 14th street. So, I don't know where that is relative to your district. But, clearly, the years where, in fact, inflation was highly volatile actually created tremendous problems in terms of planning. So I saw this by talking to my father every day at the dinner table.

When you have a stable price environment, it makes it much easier for businesses to plan. Secondly, when you have stable prices, it means that interest rates actually stay lower. So part of our so-called dual mandate, there is a third element to the congressional act for the Federal Reserve, which actually said not only do we want to have price stability, maximum sustainable employment, but also that we should have stable interest rates. Well, in order to get that, you also have to, in fact, make sure that inflation is under control.

Also, we find that when central banks control inflation better, it means that you can be more aggressive when, in fact, there is negative hits to the economy. But always you must keep your eye on the inflation ball to make sure that you do not end up in a situation such as ones we have had in the past, particularly in the 1970s, where you actually had both high inflation and actually an economy that did not do very well.

Chairwoman VELÁZQUEZ. It is no secret, sir, that the turbulence we have recently witnessed in the markets grew out of the mortgage market. The Federal Reserve lowered the Federal funds rate at both of its last meetings in response to tightening credit conditions that could restrain growth. Housing prices have leaped, vacancy rates are rising, and home starts are declining. As a result, several prominent Wall Street firms had unexpected record write-downs. Given the length of a typical foreclosure process, is it possible that the worst is still to come?

Mr. MISHKIN. Well, clearly the situation in the housing sector is one that we have to monitor very closely. The weakness in housing has been a significant drag on the economy in the second half of this year, on the order of about 1.5 percent of GDP. So this is a very significant impact. And, clearly, the housing market is not out of the woods yet. There is a big overhang of inventory, a lot of houses that builders have built and they have not yet sold, and this is actually depressing the effect on the housing market.

So one of the difficult things for a central banker is that you actually have to look at the economy. And, unfortunately, we don't have a crystal ball. Luckily, we do have a very, very strong staff at the Federal Reserve to help us think about where the economy will head, and particularly monitoring the housing market and the housing sector is absolutely one of the key things that we have to do now, because we do have to worry about the fact that housing may not do well in the future and when it will turn around.

Chairwoman VELÁZQUEZ. And isn't it true that financial institutions cannot predict as to the extent the foreclosure crisis will have on them, since the process could take from 6 months to a year?

Mr. MISHKIN. I am sure they do have some forecasts of how serious these foreclosures are going to be. It is clear that, in fact, there are going to be a lot of foreclosures down the road, and some of that has already been taken into account in terms of predictions in terms of the earnings of these financial institutions.

This is actually part of the nature of lending, that they sometimes do make mistakes; and, in fact, clearly in this instance we have had a lot of mistakes made in terms of people not being able to pay back loans. And this is something clearly that the financial institutions do have to worry about and something that we have to be concerned about as well.

Chairwoman VELÁZQUEZ. Well, let's take, for example, that in January and July of this year, Chairman Bernanke testified before the House and Senate Banking Committees to report on the conduct of monetary policy. In both hearings, the Chairman expressed confidence that weaknesses in the housing market will not spill over in the wider financial markets. Clearly, the perspective was overly optimistic.

If the downturn in the housing sector continues throughout the next year, what effect do you believe this may have on the broader markets?

Mr. MISHKIN. Well, clearly one of the things that has happened is that the problems in the mortgage sector have actually spilled over more widely to the financial markets in general. Indeed, when we think about what financial markets are supposed to do, they are basically solving information problems; they are trying to allow people to take funds and give it to people who have good, productive investment opportunities. And this is particularly important in the small business sector, which is one of the key drivers of the U.S. economies. It is really quite extraordinary how vibrant the small business sector is in this country.

ChairwomanVELÁZQUEZ. Will this affect commercial lending for the small businesses?

Mr.MISHKIN. So there are clearly a whole set of issues here, but one of the things that happened is that the markets had much more confidence in their understanding of not only what is going on in the mortgage markets, but the very complex products which are related to mortgages. And we have seen, in fact, that these surprises have meant that the financial markets have actually had a disruption, and that does have impacts on small businesses. In particular, we have seen a tightening of lending standards. We have a survey of senior loan officers, and there clearly has been a tightening of lending standards.

However, it is important to note that because the problems in the financial markets have actually been more in the securitization part of the markets, and small businesses typically do not get credit through securitization the way some other sectors have, that the impact seems to have been greater for larger firms rather than for smaller businesses. So there clearly has been an impact that this is one of the issues in terms of an economy that is weaker than we might have expected a little while ago. It clearly is one of the reasons why the Federal Reserve has acted to lower the Federal funds rate by 75 basis points in order to forestall or counteract the negative effects from this credit tightening.

ChairwomanVELÁZQUEZ. Thank you, Governor Mishkin. I have other questions, and I will come back in the second round.

Now I recognize the Ranking Member Mr. Chabot.

Mr.CHABOT. Thank you, Madam Chair.

First, I would like to talk about the credit crunch or the credit availability problem that we have. And many of us are concerned that the response to the long forecast housing and mortgage crisis has been insufficient and late in coming.

Now that communities around the country, and we see this particularly in my State of Ohio, are suffering its effects, could you discuss what should have been done or could have been done sooner and what could or should be done now, in your opinion?

Mr.MISHKIN. Well, from a viewpoint of the firms that were engaged in the business of making mortgages, clearly there were mistakes made; that there was not as good an understanding of the kind of risks that were inherent in some of the products that were produced. In fact, when we look at financial development over time, this is very common, that you have new products which eventually can actually be very useful, but in the process—and particularly solving these information problems, to actually get funds to people with productive investment opportunities—but in the process of developing them, mistakes are made.

So clearly one of the things, I think, that is going to happen is that people—that firms are going to be looking at whether the way they designed the products that they had for, in fact, getting funds to both businesses and households, whether, in fact, those were the best models for doing so. So clearly we are seeing a situation where people are trying to figure out how to, in fact, understand these products better, set the procedures up so we don't have some of the problems that have occurred in terms of loans being made to people who couldn't pay them back. And so we will see a process of getting the financial markets to work better. Unfortunately, mistakes were made, and we are paying some of the price of that at this particular juncture.

Mr.CHABOT. Thank you.

How do you anticipate that these credit and lending issues will affect small business? And what is the Federal Reserve doing to reduce the negative impact on small businesses, and especially on their employees, because that is, after all, who oftentimes pays the price when the business suffers.

Mr.MISHKIN. One of the good things is that going into this situation where we have had this financial market disruption, that the balance sheets of firms has been quite strong, and this is true for small businesses as well as large businesses, which actually helps them have the resources to weather these kinds of problems better than they otherwise would.

The other issue that I think that is important here is the nature of small businesses, which actually was pointed out in the opening statement of the Chairwoman of the Committee, that they actually have not been able to get access to certain credit vehicles the way other people have because the information about them is harder to get. Particularly if a firm is smaller and also it has been around less time, it is a younger firm, there is not as much information about it, it is actually harder to take the loan to that person and then bundle it together and then securitize it. The aspect of that actually helps small businesses now is that they are not quite as exposed as some of the other sectors of the economy.

So, nonetheless, there clearly has been an impact on small businesses because of the tightening of credit conditions, and there has been an impact in this financial disruption on aggregate demand in the economy.

In a situation like that, a central bank is supposed to act in order to counteract those negative shocks. Our job is to keep the economy on an even keel, which means prevent inflation from being too high or actually even preventing it from being too low. But it is similarly also trying to prevent economic fluctuations that are undesirable.

So in this context what the Federal Reserve has done has been to lower interest rates in order to counteract the negative shock that has occurred from the financial disruption. And, clearly, not only is that going to help the overall economy, but particularly help small businesses as well.

Mr.CHABOT. Thank you.

I had mentioned Chairman Charlie Rangel's so-called mother of all tax bills in my opening statement and voiced my concern about it. And it has been said that millions of Americans who own small businesses and who pay taxes on that income on their individual tax returns are going to face in effect what is a triple whammy. First, they will be hit with a 4 percent surtax on some of their income. Second, many of them will lose the section 199 manufacturing deduction that lowers taxes on their business income. And, third, this is happening at the same time as large corporations would be getting an across-the-board tax cut, making it even tougher for these small business engines of job creation to compete with the larger corporations and for those business owners to deal with these increases in taxes. Is that scenario one that should give us concern? Do you have any comments about that?

Mr.MISHKIN. Well, the Federal Reserve has plenty to do, but we actually don't decide on tax policy. In fact, this is exactly what our elected representatives are supposed to focus on; and so it is something that I am going to leave to you to make the decisions on.

Mr.CHABOT. All right. Well, as I said, a lot of us have an awful lot of concern about that. And hopefully reasonable minds will prevail, but only time will tell where we are at.

Finally, and this may again get into an area where you may or may not want to comment, but I am going to jump into it anyway. Would you agree that permanency and certainty in the Tax Code is beneficial to our economy, because businesses can then determine what policies they are going to be faced with and how to deal with those kind of on a long-term basis? And, in general, do you believe that the tax relief that we passed back in 2001 and 2003 helped the recent growth in our economy? And do you believe that it would make sense to make those tax policies permanent so that small businesses can depend upon those in the future?

Mr.MISHKIN. Again, I don't want to comment on tax policy, but in general, clearly the less uncertainty that you have, the better. And this is clearly an issue in terms of Federal Reserve policy; that, in fact, making sure that people think that the economy is going to not be volatile is, in fact, something that actually helps both directly in terms of actually business decisions, but also just makes people much more comfortable. So clearly there is an issue about having less uncertainty, and then the question is, how do you achieve that? And, again, on tax policy, I am going to leave that up to you.

Mr.CHABOT. Thank you very much.

ChairwomanVELÁZQUEZ. Mr. Sestak.

Mr.SESTAK. Thank you, Madam Chairwoman.

In your testimony, sir—if you don't mind, I very much appreciate all your comments about small business and all, but in your testimony, you made the very important point, I thought, the most important point, that half of all net new jobs annually come from small business.

If I could disconnect the small business just for a moment and focus on jobs, because jobs lead to wages. What is your comment about the—if you don't mind just using your expertise—that the study by AEI, conservative, and Brookings, liberal, came together, and despite all the nice prose that has been presented, that for the very first time the intergenerational promise has not been achieved in America?

It took two cohorts in the early 1970s, age 35, with some kids, about the time when you are in the prime of just beginning to say this is where I am going to be living for my kind of wages, and said, what did they earn in the 1970s real terms? AEI, with Brookings, jumped ahead 35 years when those children had grown up and were of similar age with children and said, in real terms today, the next generation for the first time in America is earning less than their parents.

How do we address that issue? Love new jobs, but the median level of real wages has declined in the last 6 years. So jobs are interesting, but wages apparently is what we really want them for. How do you fix that? How do you address that intergenerational broken promise?

Mr.MISHKIN. Well, I am not going to comment on the studies themselves. There always are very complicated issues in measuring issues, but there clearly is an issue in terms of what is happening to the median job holder, and, in particular, when you have growth in the economy, actually, how does it get spread throughout the economy. And this is an issue, for example, about the whole question about income and equality and what this means for this society.

The problem here is that the research on this indicates that it is hard to actually decide exactly what the source of these problems are. Some of the issue of what has been happening may also have to do with just the nature of technological change, which is something that central banks and even policies from the government may not be able to affect that strongly, and, in fact, some of the technological change, of course, can be very beneficial in the long run to the economy. So the problem here is that it is not obvious what the simple solution to this issue is.

Mr.SESTAK. But it is an issue, it is not the issue.

Mr.MISHKIN. It clearly is an issue that, in fact, you want to have all Americans benefit from economic growth. And this is not only true from the point of view of issues of equity, but issues from a point of view of getting everybody to buy into good policies for the country.

Mr.SESTAK. Thank you for that. I mean, because, please, take this right when I say your job is hard. I have never met a one-armed economist, because they are always saying on the one hand and on the other hand.

My next question comes then; we are $9 trillion in debt. As President Clinton handed over to President Bush the economy, the Congressional Budget Office said by fiscal 2008 we would have a $5 trillion surplus. Well, we are $9 trillion in debt today.

In 2002, this Congress, Republican Majority, decided no longer to do pay-as-you-go, which President Clinton with a Republican Congress had come to an agreement upon. And I understand your comments about uncertainty, but there was a lot of uncertainty when that was done away with.

Do you believe that, in view of not just tax, but the principle here, that there is some tough decisions to be made as 23 million Americans, if we don't get this tax thing right, will enter the AMT area and pay more taxes? So, is pay-as-you-go important, and should it be not just discretionary but mandatory funding?

Mr.MISHKIN. Again—

Mr.SESTAK. Because you talked about the principles of certainty, so I think this is kind of in your ″principles of″ area.

Mr.MISHKIN. Clearly having long-run fiscal sustainability is very important to the country. And in fact, not only is it important to the country; in order to do monetary policy well, you have to have fiscal sustainability. So one of the things we have learned from particularly looking at other countries, we haven't had as much problem here, but in the emerging market economies, in fact, that they frequently had big problems because they have not had fiscal sustainability. How you actually achieve that is again your responsibility.

Mr.SESTAK. Is pay-as-you-go—because the Federal Reserve Chairman spoke on this in years past. Is it a good principle to have?

Mr.MISHKIN. My view on this is that there are many different ways to actually try to solve the problem on fiscal responsibility.

Mr.SESTAK. On the one hand, but on the other hand.

Mr.MISHKIN. I not only have 2 hands, I also have 10 fingers. So on this one I have got to leave this up to you as our elected representatives.

Mr.SESTAK. Thanks. It is tough to get advice in this town. Thank you.

Mr.MISHKIN. Depends on what kind of advice.

ChairwomanVELÁZQUEZ. Mr. Bartlett.

Mr.BARTLETT. Thank you.

Yesterday, as you know, oil went through $97 a barrel. Is the small business community going to be more or less impacted by increasing oil prices as compared to the rest of the business world?

Mr.MISHKIN. Well, I am not sure whether there will be more or less impact because I just don't know the details. It clearly depends on what sector the small business is in. If they are very dependent on energy—so, for example, if the small business is one which is providing a service which doesn't use a lot of energy, then the impact will be fairly small. If it is a small business that is very energy-intensive, then of course the impact is larger. And I don't really have the information to tell you where small businesses—which sectors they are relative to large businesses, so I can't really be sure on this.

Clearly, the issue of high oil prices is, in fact, going to impact American businesses in general because it is a factor increasing the cost of their doing business. The good news is that, over time, American businesses have become more and more efficient in terms of using energy, and so the impact on businesses in terms of the higher energy prices is much, much smaller than it was, let's say, 20, 30 years ago where the impact was much larger. And that is very good news. This is part of the ingenuity of the American capitalist structure, that when you have higher prices and a key product for you, that you figure out how to substitute away from it.

So is it an issue in terms of businesses for higher energy prices, and also for households? Every time I know I am going to fill up my car, and it gets more and more expensive when oil prices go up, does it impact? Certainly, it does. But the potential problems from this are not what they used to be.

Mr.BARTLETT. In your role of being the primary entity that tries to stabilize our economy, you obviously need to be looking to the future. Where do you see oil prices going?

Mr.MISHKIN. Well, I am not a forecaster of oil prices. I can tell you the future markets do see that the oil prices will be coming down from their current very high levels. But the reality is that we have been very surprised, in fact the markets have been very surprised, by this very sharp run-up in oil prices that we have seen, and so there is a lot of uncertainty about oil prices. And, in fact, it is something that, because most oil is produced outside the United States, that we don't have a lot of control over.

So I think the answer here is that the best bet is that oil prices will come down from their current elevated levels, but realize there is a huge amount of uncertainty about where oil prices may be heading.

Mr.CHABOT. Will the gentleman yield?

Mr.BARTLETT. Yes, sir.

Mr.CHABOT. When you say that they are likely to come down, I would assume what you mean is in the short term; whereas, I think what the gentleman may be asking is in the long term do we anticipate that they are ultimately probably going to be going up.

Mr.MISHKIN. This is really hard, hard to decide. We clearly have had a situation where the fact that many countries that were extremely poor have been developing very rapidly, and this is particularly true of China, has actually increased demand for petroleum products very substantially. And so in that context, that does have an impact. But we also may see these countries actually realizing that they need to conserve on the use of energy. So we see actually now policies where subsidies, for example, which keep energy prices exceedingly low in some of these countries, which therefore increases demand, that they are being rethought. So exactly what will happen here is hard to say.

The other key issue here is that there is a geopolitical element to this, and a very key geopolitical element. And that is awfully hard to forecast, and there are people who are much more better qualified than I to do so.

Mr.BARTLETT. There is a bit of a scare factor in the oil price now, and for the short term oil prices may come down a little. For those who believe that in the long term oil prices will come down probably also believe in the tooth fairy.

In 1970, our country went through a phenomenon that the world is now going through. We reached our maximum oil production in 1970. And in spite of drilling more oil wells than all the rest of the world put together, we now are producing about half the oil we produced in 1970. There is accumulating evidence that the world has reached its maximum production of oil now. There will be some temporary downturns, but the future is just up, up, and away as far as oil prices are concerned.

Is there anything that the Federal Reserve or our Congress can do to minimize the negative effects of this for the future on our businesses?

Mr.MISHKIN. Well, I think that what the Federal Reserve can do is, in fact, to do our job properly. So one thing that is very important, and an important change in the success of monetary policy, is that in the 1970s when oil prices went up, the view was the that Federal Reserve was not going to be able to control inflation, and, in fact, policies were not such that inflation was controlled, and that then had very negative implications for the economy.

So, clearly, we don't want to go through that again, and the Federal Reserve, as other central banks, now focuses very much on making sure that inflation is kept under control and, therefore, has the benefits that I mentioned not only in terms of inflation control, but also in terms of the second part of our dual mandate, stabilization of the economy.

The problem here is that what can be done about oil prices. In fact, much of this is just out of control of the Federal Reserve. Clearly, there are issues in terms of, can technology help? For example, what kind of other energy sources might we be able to access? What kind of conservation can be done in terms of minimizing the use of oil?

There have been positive developments in this regard. As I said, the use of oil per dollar of GDP has actually dropped very, very substantially since the 1970s, and this is one of the reasons why the fear of higher oil prices has been much lessened than it has in the past. The economy has been really quite resilient in the face of these higher oil prices.

So, can more be done? I am sure more can be done. But the Federal Reserve, really the only thing that we can do is to make sure that higher oil prices don't spill over into higher inflation in the long run, and that also we monitor what the impact of oil prices will be also on what will happen with other economic activity.

Mr.BARTLETT. Thank you, Madam Chair.

ChairwomanVELÁZQUEZ. Ms. Clarke.

Ms.CLARKE. Thank you very much, Madam Chair, and thank you, Ranking Member Chabot.

Good morning to you, Governor.

Mr.MISHKIN. Good morning.

Ms.CLARKE. I am glad we get this chance to explore the state of small business economy. Small businesses are the engine to our Nation's economy, and we must do all that we can to ensure that all the tools are in place to create new and more jobs in this country. As we all know, successful small businesses are beneficial both from a macroeconomic and microeconomic point of view by both increasing the gross national product and personal income.

I just want to refer to what our Chairwoman has said in her statement about the mortgage market, its instability, and which has resulted in the tightening of lending standards that have spilled over into the small business credit markets, and also add to that what our colleagues have brought up about the rising oil prices, and then talk about tools that could perhaps insulate to a certain degree small business.

Microfinance, for instance, tries to expand economic opportunities and community development by providing small loans and other business services to people who have not been able to get help from mainstream banks.

Can you tell us today if there is any correlation between the microcredit movement and its impact on the national economy? And, if so, what is the economic outlook?

Mr.MISHKIN. Well, I think that improving the way financial markets work, particularly for not just small businesses, but very small businesses, is something that can be very helpful. And, in fact, in places where microfinance has been around longer, for example, in Bangladesh where it was originally set up, it actually has been able to alleviate a lot of poverty.

The issue here, again, is that having funds get to people with productive investment opportunities, even if they are poor, is actually very, very beneficial. In fact, I have done actually research on this looking at the role of finance and growth. It is actually very critical for very poor countries to have better financial systems, and microfinance is one part of that picture. It is now actually happening in the U.S. To the extent that it can help—

Ms.CLARKE. Distressed communities.

Mr.MISHKIN. In distressed communities. I think that is a terrific thing. I do know, however, that because it is micro and the word ″micro″ is in there, that it is actually still going to be a small part of the economy, not necessarily unimportant, because for the people that it can help, it could be a very big deal. But there is the issue that, in general, our financial system is, in fact, very, very large, and microfinance is only going to be a small part of it, even though it can actually target and help a very important sector of our economy.

Ms.CLARKE. In your written testimony you stated that there are many reasons why lending to small business may be riskier and may be more costly than lending to larger firms. But it has been recently reported that small neighborhood banks have been immune to the credit crisis because their loans are backed by customer deposits and not by complex debt instruments favored by major corporations. It appears what favors small businesses is their robust local economies.

Do you believe that these community banks play a pivotal role in making sure that small businesses can continue to be the engine to our country as we move forward in the 21st century?

Mr.MISHKIN. Yes. I think community banks are extremely important in this regard. In fact, research on the way financial systems work actually talks a lot about this issue, that small firms—and particularly the smaller they are and the younger they are, the more they are going to be dependent on what we call relationship finance, so that they actually have somebody who knows what they do. And particularly very small businesses, they don't necessarily have the records that a General Motors will have that you can take a look at. You actually have to have a lot of local knowledge.

One of the things that we have seen is that community banks have been a very vibrant part of the banking community, and part of the reason that this occurs is because, number one, they can get local deposits; but importantly, they have information that the big guys don't have. Because they are actually in the community, they know who is a trustworthy person. And, in fact, this is not just, by the way, for businesses, but also for households. My wife's family, my wife grew up quite poor, but her parents were always able to get loans from the local community bank, and the reason was they knew these people would pay back that, no matter what happened.

So, this idea of, in fact, having this relationship kind of financing is extremely important. And the U.S. actually has this very vibrant community banking sector which plays a very important role in exactly this regard.

ChairwomanVELÁZQUEZ. Would the gentlewoman yield?

Governor, your agency noted that a significant amount of consolidation in the banking industry is taking place. That is the trend. We discussed how small businesses have this relationship with small bankers, small banks; and small banks are less exposed because those businesses will be able to pay. So, what is the risk of banking consolidation regarding availability of financing for small businesses?

Mr. MISHKIN. Well, we know that large banks do not do as much as small business lending because they are not always set up to do so. But what we found is when consolidation occurs, that there is less lending being done by the larger entity, that other banks come into the picture, and particularly the small banks will take up the slack because they can make money from it. So what we find is that the small business sector still has been able to access credit even with bank consolidation taking place.

Chairwoman VELÁZQUEZ. Thank you for yielding.

Ms. CLARKE. Thank you, Madam Chair. You sort of stole my thunder there with that question. Thank you very much.

Chairwoman VELÁZQUEZ. Mr. Fortenberry.

Mr. FORTENBERRY. Thank you, Madam Chair, for holding this hearing.

And, good morning, Governor.

Before I make my comments, I would like to respond to the gentleman from Pennsylvania's assertion of an anti-PAYGO spirit among Republicans. I voted for the PAYGO rule.

Mr. SESTAK. May I correct that? I did not say that.

Mr. FORTENBERRY. You accused the Republicans of being against PAYGO. I voted for PAYGO, and I did so because in the same spirit I think you did, that it is an important principle to uphold that we pay for what we spend. And yet I did so with some reservations, because it does not take into account some of the dynamic effects of tax reductions as they lead to increased revenue. So that is the point I wanted to make.

The issue there raises the point as to how do we help stimulate small business capital investment, and one of the key ways was some of the tax reductions that took place that allowed for accelerated or higher levels of write-offs. We tend to point to the issues that we can quantify most easily in terms of helping small business, whether that is access to capital or education. But I don't think we have as clear of an understanding of how tax policies, such as the one implemented a few years ago that significantly raised the accelerated write-off levels, can stimulate investment, which leads to productivity, which leads to jobs, which leads to revenues and help for families. So I would like you to comment on that as well as any other barriers to entry or expansion for small businesses since it is such a critical component of our economy.

Mr. MISHKIN. Well, I am not a public finance economist, so, again, I really can't tell you what is a good tax system or not. I would rather have experts that do that for a living, focus on exactly that issue.

Mr. FORTENBERRY. Well, that doesn't help. Let me find some common ground with my friend from Pennsylvania saying on the one hand—but it would be helpful to unpack, you are an expert and in charge of our financial system, to unpack some of the either barriers to entry or barriers to expansion that we don't commonly talk about. I will give you one that we commonly raise in this hearing, and it is health insurance. Health insurance tethers a person to what they are currently doing and increases the cost of risk-taking by venturing out into a new entrepreneurial venture; that is one. But again, tax policy I think is an absolute critical component as well. It helps accelerate decisions that might be pushed off to the future to the current moment. I think that was some of the dynamic effects that we saw regarding the particular tax reduction that allowed for accelerated write-off of capital purchases earlier in this decade.

Mr.MISHKIN. If I was in charge of tax policy, I would be very happy to give you my views on this, but what the Federal Reserve can do to help small businesses is to do our job under the mandate that has been given to us by Congress. If we do that well, small businesses, I think, will prosper.

In general, the United States actually has one of the most, I don't know the exact figures, but I think we have one of the most vibrant small business economies. This is something that is a very important feature of the way that things work in this country, and it is an opportunity for people actually to actually grow rich by starting small businesses and actually working very hard.

So this is extremely important. I think the kind of environment that we have to allow businesses to do their jobs well is very important. To have a financial system that works well, so that it can get access to credit; if somebody has a good idea, they can start small. They can start it in their garage with a couple of computers and then become one of the richest people in the world. This is what makes America great.

However, the Federal Reserve, in terms of these microeconomic policies, it is not what we are actually in charge of, so on this basis, I really can't tell you exactly what the best way to solve these problems are. I think they are extremely important, and in fact, it is very important that you focus on exactly these issues.

Mr.FORTENBERRY. Thank you, Madam Chair.

ChairwomanVELÁZQUEZ. Mr. Davis? .

Mr.DAVIS. Thank you, Madam Chair.

Thank you, Governor. I would like to go back to a question that was asked a moment ago about oil prices. One of the statements that you said, and this is a quote, your job is to make sure how a process doesn't spill over into higher inflation.

Can you expand on how the Federal Reserve makes sure that it doesn't spill over.

Mr.MISHKIN. Let me qualify this. Clearly higher oil prices in the short run does spill over into inflation, but it is very important to understand that the Federal Reserve and any central bank can't determine what is going to happen, inflation, in the very short run when there are shocks, because our policies take a fairly long time to have an impact on the economy on the order of several years, particularly in terms of inflation.

So what this means is, we have to look far out and ask, will this shock to oil prices have a potential effect on inflation further out? And if it does, what are we going to do about it? And this is one of the reasons why even though an oil price shock may have temporary effects on inflation, you have to make sure those temporary impacts on inflation don't spill over into long-term impacts on inflation.

This is why it is important that the Federal Reserve make it clear that we will do what we need to, to make sure that inflation in the long run will stay stable, that is an incredibly important part of our mandate, that the great success of central banks throughout the world, or at least the Federal Reserve has been the leader in this, has been our focus on price stability. That was not always as true 30 years ago. In fact, not only did that mean we had high and variable inflation, which made it very difficult for firms to plan and actually hurt small businesses in exactly that way. But it actually led to an economy that under performed in terms of economic activity and in terms of producing jobs.

So, in this context, we really do carefully monitor what happens to oil prices. We try to make our best guesses about what might happen in the future, but actually respond to information as it comes in, but always have this long run as perspective. And this is why it is very important to not, for example, overreact to a rise in oil prices, but actually to think about what is the impact in a longer run context and then take exactly the steps that will in fact create an environment which is one which is successful both in the inflation front and on the output front.

Mr.DAVIS. I think I hear you say that part of your job is forecasting.

Mr.MISHKIN. Oh, it is a big part of our job, absolutely.

Mr.DAVIS. And with that being said, where are you in your forecasting now in the foreseeable future?

Mr.MISHKIN. Well, we have actually talked about this in the statement that we made after last FOMC meeting. Clearly, there is an issue with potentially slower growth in the short term, but in fact, we see moderate growth in a longer-term horizon. Of course, having the right monetary policy is part of getting that to happen. And indeed a reason why in fact we felt a need to lower interest rates by three quarters of a percentage point was in fact to ensure that the economy would actually keep growing at a moderate pace, and felt that we could do that and actually not have a negative consequence on inflation because of the nature of the inflation numbers have come in favorably in recent months and also that the kind of situation in the overall economy, the balance of supply and demand indicates that we hope that inflation would not rise in the future. This is something that we have to really to keep our eye on.

The difficult problem for central bankers and maybe we actually need five hands to think about, but we actually have to really balance these risks. And unfortunately, we don't have a crystal ball, but the Federal Reserve has been quite strong in its forecasting operation.

One of the great pleasures for me having come to the Federal Reserve about a year ago is to interact with our staff and the extraordinary capability of our staff, which has been very strong in terms of thinking about where the economy might be heading and giving us a perspective which I think has enabled us to do pretty well in terms of the setting of policy instruments. So this is a part of what makes central banking interesting. There is a lot of science in central banking, but there is also a lot of art as well. And I think so far we have been doing pretty well in this, but it is a tough job.

Mr.DAVIS. Let me change the question just a little bit. With small business being the backbone of our economy, the job creator in our economy, could you talk about as small business owners go out to find those loans, the increase in credit card debt amongst small businesses and what effect it is having in small businesses?

Mr.MISHKIN. There has been a substantial increase in the use of credit cards by small businesses. What we have found is that most small businesses are using it for transaction purposes, so that it is much easier to use a credit card. In fact, when I go in the store, I don't like to carry change, so I use a credit card for very small purchases. It doesn't always make me very popular with the store owner, but that's what I do. Small businesses are finding this is an important tool for them.

It is not the main source for them in terms of their financing, because they find that there are other sources of financing that are cheaper. So the credit cards do have an important role here. There are firms, particularly sometimes start up firms, you hear stories about them starting up a firm in the garage, and they borrow with their credit card. And many of those cases actually help them to become successful. But clearly, because credit card debt is not usually the cheapest form of debt for small firms, that they actually seek out other sources of financing and have been able over the years to be pretty successful at getting it, and in fact, this sector has been an incredibly important engine that broadens the U.S. Economy.

Mr.DAVIS. One last question, I am not sure if you are familiar with the Community Reinvestment Act, which doesn't require banks to lend to small business, but it does encourage. Could you talk about that?

Mr.MISHKIN. Clearly, one of the things, as a result of the Community Reinvestment Act, in fact, banks do worry about the communities that they serve. And in that context, it is not only dealing with households, which is what the Act tells them to do, but they also have outreach to small business as well. It is an important issue in terms of these communities. It is not good enough just to lend to households. Wealth generation and wealth creation is typically coming from businesses and small businesses can play a very important role in these communities.

So the banks actually do in fact try to reach out to these communities, and in fact, I think the Community Reinvestment Act by getting them to think about this in terms of households has helped them to think about this in terms of small businesses as well as.

One thing that should be said is that there is an interaction between households and small businesses. In fact, sometimes they are the same thing because—do you have a little business? I actually had something I set up for a while and then actually got rid of it, but I, at one point, was a corporation. So there was only one person in the corporation; it was me. And so, clearly, this issue of worrying about households actually means also that you indirectly worry about small businesses as well.

Mr.DAVIS. Governor, thank you and I yield back.

ChairwomanVELÁZQUEZ. Governor, since 2001, our National debt has increased by $3 trillion. Factors, such as tax policy and spending, have been responsible for that increase. What impact is there on small businesses when the government has such a large debt?

Mr.MISHKIN. Well, there are several issues here, which are, if that debt expands too much, it actually can impact on interest rates and raise interest rates. Clearly, higher interest rates make it harder to finance investments, and so it can impact on small businesses. So, again, fiscal sustainability, in the long run having fiscal balance, is actually very important in many dimensions. Clearly one of the areas it is important to is potential impact to the cost of financing for small businesses.

ChairwomanVELÁZQUEZ. In the letter accompanying the most recent survey of small business finances, former Chairman Greenspan encouraged the business owners selected for the survey to participate, noting that the data collected by past surveys has been critical for policy decisions at the Federal Reserve and in other parts of government. If the survey is discontinued, what alternative source of direct information will your agency use to make policy decisions affecting small businesses?

Mr.MISHKIN. The issue of discontinuance, I think, is an important one. The question is, what is the best way to get information about small business finance? One of the things that is very important is that the Federal Reserve be an efficient organization. In fact, the Congress has insisted that, in fact, the Federal Reserve run its operation efficiently. Part of the efficiency is, how do we get the best information in the best way?

The Federal Reserve has taken the view that we can do better by actually getting information, by getting it from the small—the Survey of Consumer Finances and that the advantage to that survey is that it is more frequent. It happens to be 3 years rather than every 5. As I mentioned, there is interaction between households and small businesses. It is very important. So one of the things that the Federal Reserve has looked at is expanding the Survey of Consumer Finances both by expanding the number of people that are asked but also by asking a lot more questions on small business finance. Our view is that, in general, that can actually provide us with a better way of getting information and also do it more efficiently.

ChairwomanVELÁZQUEZ. Sir, and if you conclude after this new survey or instrument or tool is conducted, put together, that it doesn't reflect small businesses, will you go back to have your own small business survey?

Mr.MISHKIN. Well, certainly, if it is not getting the information we need about small businesses, we will in fact figure out how to improve it.

ChairwomanVELÁZQUEZ. I cannot stress enough how important this survey is for us Members of Congress when we are dealing with decisions, policy decisions. And I guess that you need to look at how we do business here. And when it comes to small businesses, quite often they are overlooked. Either tax policies or energy policies or any type of tax relief, they become an after thought. And I don't want for that to happen when you need to have information in order to make decisions that are important to small businesses.

With that, I will recognize Mr. Chabot.

Mr.CHABOT. Thank you, Madam Chair. I just have a couple more questions. I don't think they will be too long.

We have had a number of hearings here about more and more small businesses are engaging in trade. And as part of their profit and bottom line is their success or lack of success in trading. And we have got a couple of trade agreements before us now, Peru, Panama, South Korea, Colombia. And they are somewhat controversial, depending on the country. And I tend to be one who thinks it is good for us to be trading. We ought to keep tariffs down and all that sort of thing.

We also have issues, such as China artificially manipulating. Their currency has been discussed, things of that nature. I don't want to ask a specific question, and say, hey, that is your job. I have thrown it out there. What can you tell us about trade that could be helpful to us?

Mr.MISHKIN. I think actually having the U.S. Economy participate very fully in the global economies is actually critical to our economic well-being. First of all, it promotes competition, and one of the things that makes the American economy so strong is, in fact, that you have to be competitive. This means you actually have to produce a better product, and by producing a better product, you do better. And indeed, having competitive markets is really the engine of our productivity growth, because when you have competition, you have to do a good job. And if you don't, you don't stay in business very long.

So also being very open to global markets means that if somebody is making a product cheaper abroad, then in fact either you have to get better and improve the quality of your product and lower its price or you are going to find that you are going to be in trouble in not being able to sell the goods. What we have found is American businesses have been able to perform extremely well, and we have an economy in fact that has very high employment right now. So, in that context, my view is that trade is something that is an important element in a successful economy. And turning our backs on the global economy would not be very healthy, and it of course would be very unhealthy for other countries as well.

Mr.CHABOT. Thank you. Just to follow up on that, those that are more skeptical about trade and freer trade—I won't say free trade, but freer trade—argue that manufacturing jobs and other jobs end up going overseas, and there is a net loss of jobs they would argue. They would also argue, even if we do create more jobs here, they tend to be low-paying jobs that don't have benefits. They are flipping hamburgers at McDonald's, that type of thing. That is sort of the rhetoric that you hear out there. To the extent you are able to, could you shed any light on whether those allegations are for the most part true or for the most part not true?

Mr.MISHKIN. Well, we have certainly seen that, with this increase in globalization, that we have not had a problem producing jobs in this country. So it is true that there are people who are hurt because they lose jobs because they are in competition with workers abroad, but there are also new jobs that get created.

So the issue, of course, is how do we deal with some people that maybe could get hurt by this. This is something again that I think the Congress has to think about because it is important. But on net, the global economy has been very helpful to the overall U.S. Economy. And clearly, our ability to actually come up with good ideas and actually have them used abroad is also helpful to countries elsewhere.

So, in terms of employment, certainly the economy, which in fact has had employment grow very substantially over time, and in fact, during this period of increased globalization, employment growth has been very rapid in the United States.

Mr.CHABOT. Thank you.

Finally, relative to the spending and the national debt and our deficit that we have each year, some would argue that we still have a few hundred billion dollar deficit each year, and to some extent, it went up. When I came up here and the Contract with America, that was one of the main things, balance the budget; it got balanced because of Congress and President Clinton. I will give him credit as well. We worked together and got it done, some credit, not all of the credit—

Mr.GONZÁLEZ. Yeah.

Mr.CHABOT. Not all the credit but at least some of it. As one of the House managers who was involved in the impeachment of the President, I am sure he'll appreciate me saying that. I will give him some credit for that.

Now, unfortunately, since that time, we had September 11th. We had the stock market plunge. We had the bubble burst of the Internet stocks and all that stuff. And we're now fighting a war in Afghanistan and Iraq. And we have additional expenditures, et cetera, et cetera. So the deficit shot back up, and it seems to be coming down again, although not as fast as a lot of us would like it to. But what I am getting at, you will hear people say the deficit, even though it is X amount, if you look at it in terms of the overall GDP as a percentage, it is not as high as it was earlier, and therefore, it is not really as big a deal. I am not saying that, but I am saying that is what some will argue.

The impact that all of that has on the economy and job growth in the future, could you comment on that?

Mr.MISHKIN. Again, I think this issue of fiscal sustainability is very important. The point here is not just what the deficit is now; it is the long run wrong fiscal sustainability that is very key. In fact, it is not just our current spending versus revenue, but also what kind of obligations do we have in the future, for example Social Security and Medicare? And this is something that I think is something that I do worry about. I think it is something that should be a major concern for Congress. But then how to actually deal with this and get fiscal sustainability to happen—that is why you get paid the big bucks.

Mr.CHABOT. Thank you very much.

I yield back, Madam Chair.

ChairwomanVELÁZQUEZ. Mr. González.

Mr.GONZÁLEZ. Thank you very much, Madam Chairwoman. My apologies to my colleagues and to the witness for being late. We always have two or three things and still try to make it, and I appreciate your patience. I don't know if you have covered this. If you have, I will just move onto the next question, but did you all cover the Community Reinvestment Act? I know you touch on it in your testimony.

Mr. MISHKIN. There was a question from Mr. Davis on exactly that issue.

Mr. GONZÁLEZ. The question really goes to how active the banks are today with the mergers and such. I know, in San Antonio, we only have fewer banks. In essence, community banks hardly compete anymore and, of course, with the mergers and such of the banks. Is there any attention being paid to the CRA obligations to the banks? Because we know when they comply, then small business men and women definitely benefit. And I don't know if Mr. Davis basically asked the same question. You already answered it, and if he did, I can move on.

Mr. MISHKIN. Certainly our compliance with the Community Reinvestment Act is something that the Federal Reserve scrutinizes carefully. It is part of what we are supposed to do to make sure that the banks are doing what they are supposed to be doing in these communities. And so part of our supervisory process is to look at banks in this regard and to ensure that they are complying with the Act.

Mr. GONZÁLEZ. And with the mergers, if you have fewer players, how does that impact, if anything?

Mr. MISHKIN. I think, if there are fewer players, it doesn't change the need for them to comply.

Mr. GONZÁLEZ. No, no, I understand that.

Mr. MISHKIN. The bigger players, we have to supervise them similarly to the way we have to look at smaller players.

Mr. GONZÁLEZ. Do you have any report that is forthcoming or any recent studies? I know Barney Frank, in Financial Services, was thinking of having a hearing on it. I don't know if that has transpired. Madam Chairwoman you may be more aware of that.

Chairwoman VELÁZQUEZ. No.

Mr. GONZÁLEZ. Are you doing anything on it?

Mr. MISHKIN. I'm not sure, but if we are doing something on it, I would be happy to get back to you on it.

Mr. GONZÁLEZ. If you would, I would really appreciate that.

On free trade agreements, this came up the other day when we had the ambassador with the trade representative being here: Why is it important to include environmental and labor provisions in there as far as compliance, a regulatory scheme that we want to make sure is imposed on our trading partners?

Mr. MISHKIN. Well, again, I really don't want to comment on the details of free trade agreements. I have expressed that I am somebody who believes that the global trade is a positive influence on the American economy. And also, I think importantly, a positive influence on economies elsewhere in the world where very many poor people in the rest of the world in fact benefit by a global economy. In fact, one of the great things about our history is that the U.S. Actually encouraged this global economic system after World War II.

Mr. GONZÁLEZ. I understand the international implications and good policy; we need to be engaged and so on. The point I am always trying to make from a business perspective is, we need a level playing field for our domestic men and women. So if we have a regulatory scheme that actually imposes greater costs on the product or service that we actually provide and they don't, it is a tremendous disadvantage. A lot of people say, you are into the environment because you are a tree hugger or into labor because you are being pro-labor. Well, you know, you may be. But the other reasons are very practical and very important, and I am afraid that we just have never really emphasized that part of it.

The last question I have is just the cost of energy and the potential economic impact. I mean, we are going to have $100 barrel of oil. It hasn't translated yet to the pump, but it is going to, obviously, by Christmas, if not sooner. But look at the small business impact. They are on the margins all of the time. They don't absorb or don't get to really pass on as easily as, I think, some of the bigger outfits. Are you evaluating the rising costs of energy? I am not just talking about gasoline but natural gas and such. This is going to be huge this winter.

Mr.MISHKIN. We do actually look carefully about what is going on in terms of the energy markets and the impact both on businesses and households. So, clearly, there is an issue of, what is the relationship, for example, to what is happening in oil prices to gasoline prices? What impact does it have on natural gas prices? These prices actually do have an important impact on the economy. And in fact, it is something we have to monitor in order to think about what is going to happen to the economy in the future. We talked about we have to forecast in order to do policy well. And indeed, thinking about what the role of energy prices and the higher energy prices that we've experienced lately has on the economy is in fact a key element of what we have to do in thinking about how we conduct policy.

Mr.GONZÁLEZ. My concern is the disparate impact that it has on small businesses. They are just too close, as I always say operating on the margins. So when their operating costs go up, it really is— I am not sure if the Fed looks at the very distinct position that small business has, as opposed to in the overall economic picture and then we can say, gee, they are the economic engine of the United States and stuff, but the truth is we don't really look at specifically what relief will we try to provide them to confront and actually survive, because I don't think they survive very long, but again, thank four your testimony, and I yield back.

ChairwomanVELÁZQUEZ. Questions?

Well, Governor, thank you so much for your contribution this morning.

Mr.MISHKIN. My pressure.

ChairwomanVELÁZQUEZ. Members will have 5 legislative days to submit statements for the record. Without objection this hearing is adjourned.

[Whereupon, at 10:30 a.m., the committee was adjourned.]

STATEMENT
of the
Honorable Nydia M. Velàzquez, Chair
House Committee on Small Business
Hearing on the State of the Small Business Economy

I am pleased to call this hearing to order.

Thank you all for being here today. Today's hearing will examine the production, employment, and output of our nation's small businesses as drivers of the U.S. economy.

There can be little doubt that at its heart, our nation's economy is truly a small business economy. Research has shown that small businesses create most of the nation's net new jobs and account for almost half of our employer firms. Additionally, they produce more than half of the country's non-farm private output. It goes without question that small firms make significant contributions to the U.S. economy.

Today's hearing will provide a forum to hear the Federal Reserve's perspective on small businesses' contributions to the economy. This comes at a time where we are seeing mounting challenges in the financial markets. These challenges, stemming mainly from the housing market, may spill over to other sectors of the economy. This would have broad ramifications, including an impact on small businesses.

Despite this recent turmoil, small businesses remain a critical source of growth. The number of new businesses, measured as the number of firm births, has shown a net increase of over 20 thousand since 2004. Just last week, the Labor Department reported nationwide job growth of 166,000 new jobs and a stable rate of unemployment. Small businesses were at the heart of these metrics, and whatever our economic future may hold, we can be assured that small businesses will be the vanguard for production, job creation, and output nationwide.

Recently, however, we've witnessed increased volatility in the capital markets. These conditions have been driven primarily by weaknesses in the mortgage sector, but virtually every business sector has been affected by these events. Mortgage market instability has resulted in a tightening of lending standards that has spilled over into the small businesses credit markets. Indicators reflect that entrepreneurs are experiencing difficulty obtaining credit and more banks are reporting lower demand for small business loans.

I am sure it comes as no surprise to members of this Committee that small businesses have more difficulty gaining access to affordable sources of credit compared to large businesses or other types of borrowers. Unfortunately, the most recent Federal Reserve Report on the Availability of Credit to Small Businesses reveals that this continues to be the case.

Small businesses continue to rely disproportionately upon more expensive alternatives to traditional credit than larger businesses. Additionally, the percentage of small businesses that used credit cards increased nearly 10 percent since the last Federal Reserve survey. These results demonstrate the need for strong SBA programs aimed at providing small firms with access to affordable sources of financing.

Yet, despite the obvious importance of small businesses, there remain few studies on their economic role. In addressing the need for solid information on small businesses, few studies have been more influential than the Federal Reserve's Report to Congress on the Availability of Credit to Small Businesses.

Much of the information contained in the report is gleaned from the Survey of Small Business Finance, which is itself the most comprehensive and up-to-date direct assessment of small business finance. Over the past decade, this report has provided Congress with invaluable insight into the small business credit markets.
Now more than ever, such insight is a key resource in developing balanced and effective economic policies. With the economic turmoil we have seen recently, it is paramount that we all work together to restore financial market stability and offset the effects of tighter credit conditions.

These developments have created uncertainty over our economic future. Our history has proven that as small businesses go, so goes the national economy. In this environment, it is more important than ever that this Committee remain committed to ensuring that small businesses have access to the financial tools they need to grow and thrive.

I want to thank Governor Mishkin for his testimony in advance and I now yield to Ranking Member Chabot for his opening statement.

Opening Statement

Hearing Name	The State of the Small Business Economy
Committee	Full Committee
Date	11/7/2007

Opening Statement of Ranking Member Chabot

Good morning. I thank all of you for being here today as we examine the state of the small business economy. Before we begin, I want to sincerely thank and welcome you, Governor Mishkin, for taking time out of what is an invariably busy schedule to appear before this committee this morning. I appreciate the work you do at the Federal Reserve and I am certain that each of my colleagues here on this panel do so as well.

While the U.S. economy faces real challenges - credit worries, rising energy costs, and a slowing housing market among them - the October Bureau of Labor and Statistics employment summary and the preliminary estimates of third quarter GDP growth show an economy that is expanding. Job growth in the third quarter was the strongest since the early spring of 2007 with an estimated 166,000 new jobs created in October. The strongest month for job creation since May, October marked 50 months of consecutive job growth.

In addition to these positive trends, we have seen wages increase and growth of the Gross Domestic Product (GDP) remain steady. These numbers surpassed expectations, indicating entrepreneurs and small businesses continue to create new jobs and the labor market and overall economy remains strong.

These numbers provide great insight into the strength of our small business economy. Because of their importance to our overall economic health - and we all know the statistics - we must continue to be mindful of how the policies we pursue and enact here in Congress will affect small businesses as we move forward.

I am concerned over some of the tax policy initiatives that have been coming from the Ways and Means Committee leadership in the last few weeks. As the White House noted, the most recent legislation would dramatically raise taxes on millions of small businesses, stifling their ability to grow and create jobs. Coupling this legislation with runaway government spending and we are setting up a scenario that would put a wet blanket on future growth. Small businesses are vital to future economic growth and I believe that these regressive tax and spending policies put our economic well-being in danger.

I am very eager to hear today how the Federal Reserve Board is responding to the credit crunch in the wake of the housing market downturn. I am interested to learn the Board's forecast for how the credit crunch is affecting our small businesses now and how further trickle down from the housing market fallout will affect them in the future. I think I speak for many of my colleagues when I say that we in Congress would like to know how we can help both individual Americans and businesses weather the current credit market.

I look forward to working with Chairwoman Velazquez and all of our colleagues in this committee to ensure this Congress does more than just talk about how small businesses are our economic engine, but also acts in accordance with that reality. Under the chairwoman's leadership, this committee has remained cognizant of small firms' proficiency in generating jobs and ability to grow our economy and we will continue to ensure small businesses receive their fair shake.

Again, thank you for taking the time to be with us today and I look forward to hearing your testimony. I yield back.

For release on delivery
9:00 a.m. EST
November 7, 2007

Statement of

Frederic S. Mishkin

Member

Board of Governors of the Federal Reserve System

before the

Committee on Small Business

U.S. House of Representatives

November 7, 2007

Chairwoman Velázquez, Ranking Member Chabot, and members of the Committee, I am pleased to appear before you on behalf of the Board of Governors of the Federal Reserve System to discuss the availability of credit to small businesses. Small businesses, generally defined as firms having fewer than 500 employees, are critical to the health of the U.S. economy. For example, small businesses employ more than half of private-sector workers, generated well over half of net new jobs annually over the past decade, and create more than half of nonfarm business gross domestic product. Moreover, larger firms often begin as smaller firms that prosper and grow. If small businesses are to continue to provide major benefits to the economy, their access to credit is clearly a high priority.

The first and largest part of my statement will cover the highlights of the Board's most recent periodic report to the Congress on the availability of credit to small businesses, which was submitted on October 26.[1] The second portion of my testimony will address the unusual stress imposed on credit markets in recent months and how that stress may affect small businesses. By necessity, the latter remarks are preliminary and subject to an unusually high degree of uncertainty.

Highlights of the 2007 Report to the Congress

As you know, the Board is required by law to report to the Congress every five years on the status of small business access to credit. The current report covers the period from mid-2002 (generally the time of the latest data in the previous report) through June of this year. Looking first at an aggregate level, and using a variety of data sources, our 2007 report indicates that, since 2002, financing flows to both small and large firms generally increased along with economic activity. Credit conditions during the period were favorable for small and large firms,

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[1] Board of Governors of the Federal Reserve System (2007), *Report to the Congress on the Availability of Credit to Small Businesses,* submitted to the Congress pursuant to section 2227 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (Washington: Board of Governors, October).

and we have no evidence that creditworthy borrowers faced any substantial constraint on their access to credit. The demand for credit by small businesses generally tracked the pattern for nonfinancial businesses overall. Indicators of financing needs for small businesses suggest that demand picked up in 2004 from low levels in 2003 but moderated in 2006 and early 2007.

Looking more deeply, our report discusses the sources and types of credit used by small businesses, the effects of developments such as bank consolidation, increased use of credit scoring and securitization, and the role of community development activities on the availability of credit to small businesses. Moreover, underlying the congressional mandate to produce this report is a concern that small firms have more difficulty gaining access to credit than do large businesses. The source of this concern may be that lending to small businesses is generally considered riskier and more costly than lending to larger firms. For example, small businesses tend to be much more affected by swings in the economy and have a much higher failure rate than larger organizations.

In addition, lenders historically have had difficulty determining the creditworthiness of some applicants for small business loans. The high level of diversity across small firms, together with their widely varying uses of borrowed funds, has impeded the development of general standards for assessing applications for small business loans and has made evaluating such loans relatively expensive. Lending to small businesses is further complicated by the fact that reliable information on the creditworthiness of a small business is often difficult to obtain because little, if any, public information exists about the performance of most small businesses. Small businesses rarely issue publicly traded equity or debt securities, and many small businesses also lack the detailed balance sheets and other financial information used by lenders in making credit decisions.

Financial institutions, especially commercial banks, are thought to have an advantage in dealing with information problems. Through interactions with a firm that uses its services, including the firm's owners and key employees, a financial institution can obtain information about the firm's activities, ownership, financial characteristics, and prospects that is important in deciding whether to extend credit and on what terms. Employing what is often called "relationship finance," banks and other financial intermediaries can use information gathered over time through long-term relationships with small businesses and other members of the local community to monitor the health of the small businesses to which they lend and to build appropriate terms into loan agreements.

Results from the Board's 2003 Survey of Small Business Finances (SSBF) support the view that commercial banks have an advantage in lending to small businesses. The survey data show that, although small businesses obtain credit from a wide range of sources, including savings institutions, credit unions, finance companies, nonfinancial firms, and individuals such as family members or friends, commercial banks are today, as in the past, the leading provider. For example, commercial banks supplied traditional credit--credit lines, loans, and leases--to slightly more than two-thirds of small businesses that obtained such credit from any source. Banks were also the most common source of mortgages and equipment loans, and they were second only to finance companies as the source of automobile loans.

Data from our 2003 survey also indicate that among small businesses, relatively large firms (whether measured by sales, assets, or number of employees), and relatively older firms, were more likely than smaller or younger firms to use a wide range of types of credit, including credit lines, capital leases, motor vehicle loans, mortgages, and equipment loans. The reasons for these differences are unclear; it may be that larger or older firms have more-complex funding needs, or perhaps lenders are simply more willing to extend credit to larger or older firms.

In addition to traditional sources of credit, small businesses often use alternative sources, including credit cards, trade credit, and owner loans. Of the alternative sources, only business credit cards registered an appreciable increase in usage between 1998, the year of the Board's previous SSBF, and 2003. Although most small businesses used credit cards and trade credit, the rapid payment of outstanding balances by a large percentage of these firms suggests that much of the use of these products was for convenience rather than for longer-term financing.

The amount of credit that the SSBF and other data sources indicate was used by small businesses may have been less than the amount those firms desired, especially smaller and younger firms. According to our survey, about 20 percent of small businesses applied for new credit between 2000 and 2003, and more than 80 percent of those firms had an application approved. Relatively larger small businesses (again, whether measured in terms of sales, assets, or employees) were more likely than smaller firms to apply for new credit and were more likely to have their applications approved. In addition, although the proportion of small businesses applying for credit did not vary much by age of the firm, younger firms were more likely than older ones to be denied credit. The finding that both smaller and younger firms have their loan applications denied more frequently is consistent with the conventional view that these firms are riskier, have shorter credit histories or less collateral to pledge as security, and are generally harder for lenders to evaluate because they are less transparent.

Because banks are the leading source of traditional credit to small business, much attention has been paid to developments in banking that may influence credit availability. The substantial consolidation of the banking industry over the past twenty years is one such development. Mergers and acquisitions have dramatically reduced the number of banks, thereby increasing the concentration of industry assets and the importance of large institutions. Although larger banks supply the majority of bank loans to small businesses, small business loans tend to comprise a smaller proportion of assets at larger banks than at smaller banks. Hence, the changing structure of the industry has raised concerns about possible reductions in the availability of credit to small businesses.

Studies that directly analyze the relationship between bank consolidation and the availability of credit to small businesses tend to suggest that, although mergers and acquisitions may sever existing bank-firm relationships and may introduce some short-term uncertainty, bank consolidation overall has not reduced credit availability to small businesses. After a merger, any reduction in small business lending by the newly consolidated bank is generally offset by an increase at other banks. In addition, the evidence suggests that the thousands of small banks still in operation continue to account for a meaningful share of small business lending. For example, in 2006, about three-fourths of banks had assets of $250 million or less. Although such banks accounted for only 5 percent of all banking assets, they held a disproportionately large share of all small loans issued by banks to businesses: 16 percent for loans of $1 million or less and 21 percent for loans of $100,000 or less.

As was true of our 2002 report, the 2007 report emphasizes the importance to small businesses of geographic proximity to their source of credit. For example, our data indicate that in 2003 the median distance between a small business and its lender of any type was 11 miles (4 miles for depository institution lenders); and the lender was located within 30 miles of the firm's headquarters in 66 percent of all small business lending relationships (in 83 percent of relationships with depository lenders).

The importance of local providers of credit to small businesses underscores the need to preserve competitive banking markets at the local level. Despite the significant consolidation in the banking and thrift institution industry, the data indicate that competitive conditions in the nation's local banking markets have remained quite stable. For example, since 2002, measures of average market concentration in both urban and rural banking markets have either declined slightly or remained the same. In short, the slight reduction in concentration seen in local markets in recent years suggests that the availability of small business credit from commercial banks and thrifts has not declined.

Credit scoring has been used for more than thirty years in underwriting consumer loans, but it has become common in assessing small business credit applications only since the mid-1990s. On the one hand, the use of credit scoring for small business lending has raised concerns that it may disadvantage firms that find it difficult to qualify for loans on the basis of only a formal credit score. On the other hand, credit scoring may increase the availability of credit for small businesses by improving the consistency, objectivity, and speed of credit evaluations while lowering the cost of gathering relevant information. In addition, it may have the potential to increase a lender's ability to accurately predict loan performance and may increase access to capital markets. Evidence to date regarding the effect of credit scoring on credit availability is consistent with the view that the use of scoring models increases the availability of credit to some small businesses.

Additionally, because the use of credit scoring models in small business lending has only recently become more commonplace, at this time, it is not clear how small business credit-scoring models perform relative to traditional reviews of such loans, especially during a major economic slowdown. However, users of the models generally report that, after their adoption,

(1) the riskiness of the small business portfolio either remains about the same or declines, and (2) the quality of the typical credit decision increases.

Loans to small businesses operating in low- and moderate-income areas may be influenced by the obligations of insured depository institutions under the Community Reinvestment Act (CRA). The CRA does not require that banks lend to small businesses, but it reaffirms that federally insured banks and thrifts have continuing and affirmative obligations to help meet the credit needs of all the communities they serve, including low- and moderate-income neighborhoods. Although much of the small business lending of depository institutions in such neighborhoods cannot be directly attributed to the CRA, bankers and community representatives indicate that some of it is the result of individual institutions responding to their CRA obligation. Beyond conducting lending programs that are part of their normal operations, banks often develop or work with specially created entities focused on providing credit in underserved communities. Some of these entities operate wholly within a bank's legal structure, some are partnerships with other service providers, and still others are stand-alone organizations in which banks invest. These programs encourage credit and equity capital to flow where it otherwise might not.

In addition, a number of trends in the community development field either are just beginning to influence the delivery of capital to small businesses or have the potential to do so in the near future. Some of these trends, such as the proliferation of financial literacy and outreach programs, are primarily initiatives of financial services firms themselves. Others result from government actions to stimulate lending. Still others involve new hybrid partnerships among banks and nonbank entities such as local microloan funds, a subject addressed yesterday by

Chairman Bernanke in a speech in San Antonio. These trends, should they continue, are likely to result in improved access to credit and capital for small businesses.

A final topic addressed in our report is the securitization of small business loans, a development that could substantially influence the availability of credit to small businesses. Securitization offers potential benefits for lenders, borrowers, and investors. However, the obstacles to securitizing loans to small businesses are large, especially for loans not backed by a guarantee from the Small Business Administration (SBA). As a result, securitization has so far remained modest and is unlikely to increase substantially over the foreseeable future.

Small Business Finances and Recent Financial Market Developments

Financial market conditions began to deteriorate quite rapidly in the middle of August. Although conditions have steadily, albeit gradually, improved over recent weeks, problems could spill over to the market for small business loans. In recognition of this possibility for small businesses and other sectors of the economy, the Federal Reserve's policy actions during this period have been aimed both at restoring financial market liquidity and at helping offset the effects of tighter credit conditions on the broader economy.

I will briefly address the possible effects of the recent turmoil on small business access to credit. I emphasize that the possible effects are complex, that we do not yet have much hard evidence, and that it is far too early to draw any definitive conclusions. Thus, my comments should be viewed as preliminary and subject to an unusually high degree of uncertainty. I assure you, however, that the Federal Reserve is monitoring market conditions closely in an effort to better understand the combined effects of the housing market slowdown and financial market stresses.

There are good reasons to believe, and some evidence to suggest, that the recent financial market disruptions have not seriously harmed access to credit by small businesses, and if the disruptions continue to be resolved in an orderly manner, will be unlikely to do so in the future. For example, the current turmoil has centered on securities backed by nonconforming residential real estate loans and loans or other debts of relatively large firms; so-called collateralized loan obligations (CLOs) and collateralized debt obligations (CDOs). Because, as I discussed earlier, the securitization of small business loans is still quite modest, we would not expect turmoil in the markets for securitized assets to have a large direct effect on small business lending.

In addition, it is the relatively large banks that are deeply involved in the loan securitization markets and that have sometimes chosen to conduct a significant portion of their business through so-called conduits, many of which have contracted rapidly in recent months. In contrast, it is the smaller banks that specialize in "relationship finance" to small businesses. These banks are relatively unaffected by disruptions to the securitization markets. Thus, once again, we would expect that the direct effect of current events on small businesses would be limited. Indeed, the data we have on business lending at small banks show that such loans have continued to expand at a fairly robust pace through mid-October. Such data and our conversations with bankers suggest that, at least to date, the supply of credit to small businesses remains healthy.

Although these arguments and evidence are encouraging, recent events have nonetheless almost surely had some negative effects on small business access to credit, and we cannot rule out further effects. We know that risk premiums embedded in interest rates have increased across a wide range of debt instruments, that credit standards have tightened for most types of lending, and that investors are continuing to reassess both the risks of and the prices they are willing to pay for assets they are considering adding to their portfolios. Because loan terms, both risk premiums and credit standards, had previously been unusually low, in many ways these are welcome and healthy developments that, over the longer term, will produce a more efficient and stable financial system. But for many borrowers, including some small businesses, these developments also mean that credit now is, and will probably continue to be, less available and more expensive than it was a few months ago.

Recent surveys have found evidence that the market for small business credit has tightened. For example, the Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices, conducted most recently in October, indicates that banks generally tightened loan terms for all types of business borrowers over the previous three months. The most recent monthly survey of small business conditions sponsored by the National Federation of Independent Business (NFIB), conducted in early September, finds that the net percentage of small business respondents that had found credit harder to obtain over the previous three months and the net percentage that expected credit conditions to tighten over the next three months both reached levels not seen since the early 1990s.[2] Likewise, the Duke University/CFO Business Outlook survey for September reported that about one-fourth of the chief financial officers (CFOs) of small businesses that responded found credit to be more costly, or less available, or both following August's financial market turmoil.[3]

While these survey data certainly suggest that some tightening has occurred, it is important to observe that they also suggest that, at least for now, the effects have generally been quite limited. For example, a deeper look at our October Senior Loan Officer Opinion Survey

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[2] About two-thirds of survey responses were collected before the September 18 policy easing by the FOMC.

[3] The survey was concluded on September 7.

data reveals that the tightening of terms on loans to small businesses was typically less severe than the tightening on loans to larger firms. Moreover, our survey indicates that small business loan demand held up rather well between our July and September surveys. In the NFIB survey, only a very small fraction of business owners cited the cost and availability of credit as their principal business concern. Indeed, in the commentary on its survey results, the NFIB has continually emphasized that borrowing to finance normal production is still running smoothly. In addition, both the NFIB's index of small business optimism and the fraction of firms in the survey that consider the next three months "a good time to expand" have remained at levels similar to those seen in the first half of this year.

Perhaps one of the most important concerns about the prospects for small business access to credit is that many small businesses use real estate assets to secure their loans. For example, data from our 2003 SSBF indicate that 45 percent of the total dollar amount of small business loans outstanding in 2003 was collateralized by some type of real estate asset. About 37 percent was collateralized by business real estate assets, and 15 percent was secured with "personal" real estate.[4] Looking forward, a reduction in the value of their real estate assets clearly has the potential to substantially affect the ability of those small businesses to borrow.

Similarly, declines in the value of real estate assets held by banks and other lenders may affect their ability to supply loans, as real estate losses use up capital that could otherwise be used for making new loans. In addition, if banks place on their balance sheets some assets that they had expected instead to place in conduits or otherwise sell to investors, the move could crowd out loans to small businesses and other borrowers. In fact, business loans surged in September and October primarily at large banks and banks affiliated with securities firms,

[4] The two components sum to more than 45 percent because some loans are collateralized by both business and personal real estate.

institutions that, due to financial market conditions, likely had to retain on their books larger-than-expected portions of syndicated loan deals.

Fortunately, the vast majority of U.S. banks are well capitalized and thus should be able to maintain their lending capacity. In addition, lender constraints on small business loans may be mitigated somewhat by loan guarantees provided by the SBA. In the past, following declines in bank capital, the volume of loans associated with SBA guarantee programs contracted considerably less than the volume of other loans. However, as our report points out, SBA guaranteed loans are only a small portion of total small business loans. Thus, the possibility remains that reductions in real estate values and a permanent reassessment by investors of the risk of various financial market instruments could significantly affect access to credit; the Board will be monitoring the economy for signs of such an effect over the next few months.

The interdependencies between small business and household finance are among the most interesting and least understood aspects of small business access to credit. In addition to personal real estate assets, other household assets such as automobiles may be used as collateral for small business loans, and personal credit cards and savings accounts are sometimes used to help finance a small business. For example, our report documents that, in 2003, almost 47 percent of small businesses used personal credit cards in the conduct of their business. Most of this use appears to have been for convenience rather than longer-term borrowing. Nonetheless, such data suggest that a significant decline in the financial condition of households, should it occur, would be likely to affect economic activity through its influence on small business finances over and above the more traditional effects of such a decline on the aggregate consumption of the household sector. Thus, the interaction of the household and small business sectors is another area that the Federal Reserve will be monitoring over the coming months.

Conclusion

In conclusion, the health of the U.S. economy depends importantly on the vitality of the small business sector, and continued access to credit on competitive terms is central to that vitality. Our 2007 report to you indicates that, since our 2002 report, small business access to credit has been robust. Credit conditions have no doubt tightened since mid-August, but small businesses seem generally to have been able to retain access to credit. However, the effects of recent events are complex, the data are spotty and mixed, and it is far too early to draw any firm conclusions. Moreover, the current level of uncertainty about the future is unusually high. Thus, the Federal Reserve will continue to monitor closely the effects of current financial market conditions on small business finances as part of its efforts to ensure that distress in financial markets does not spill over into the broader economy. More generally, I assure you that the continued good health of the small business sector is an important consideration for the Federal Reserve as we strive to fulfill the dual mandate given us by the Congress to promote both price stability and sustainable economic growth.